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Sovereign Debt Restructuring- A Perspective from China After COVID-19*

I. Introduction

Over the past several decades, sovereign bonds have become one of the leading investment vehicles in the world. The consequences of the financial crisis 2007-09 and the subsequent sovereign debt crisis have highlighted the critical linkages between different national economies, and between sovereign debt management, financial stability, and systemic risk. The recent COVID-19 crisis has set the stage for a debt crisis and even a broader financial collapse due to the increase of financial fragility. In particular, China has received a wave of applications for debt relief from crisis-hit countries included in the Belt and Road Initiative ('BRI'), the world's most extensive development programme. The advent of the global financial crisis 2007-09 and the subsequent sovereign debt crises have highlighted how vital an effective scheme of sovereign debt restructuring ('SDR') can be for the international financial stability. The markets for sovereign debt have been around for centuries. In addition, structural changes in the global economy have led to a spectacular rise in sovereign debt relative to GDP. The potential threat to both regional and global economic stability in the case of sovereign default has been clearly illustrated by the case of the European sovereign debt crises, and numerous other governments worldwide have sought international assistance to deal with the debt crises. The contemporary moment demands that serious contemplation is given to the question of how best SDR can be regulated and administrated at the international level.

Currently, there is no universal international sovereign debt regime for nations to address disputes regarding the SDR under the BRI framework, and there is an increasing concern about international investment agreements ('IIAs') and arbitration aroused by those IIAs may become the 'court' for sovereign workouts by default. However, most of the bilateral investment treaties ('BITs') between China and those countries took part in the BRI are very conservative on the scope of the disputes that can submit to international arbitration. This paper will critically analyse the impact of COVID-19 on the SDR and litigation issues. The first part will provide an overview of the current sovereign bond (debt) market and SDR in China. Moving on to the overview of the current sovereign bond market and SDR, the paper will focus in particular on whether the existing approaches for SDR are adequate to protest investors in the BRI. Building on this analysis, the paper will examine the way how the global health emergency of COVID-19 impact the drafting of future IIAs between China and other BRI countries. Also, the paper explores the potential reform to the current approaches for SDR, as well as the potential reform of the current IIAs.

II. Overview of the Current Sovereign Bond Market and Sovereign Debt Restructuring in China

Generally speaking,'[t]he market for sovereign debts grew over time and there were several changes in the nature of the bondholders and banks'.[1] Nowadays, creditors of sovereign debts may be very different in nature in terms of its class, including banks, bondholders, international financial institutions, or other sovereign governments.[2] *Abbas*, *Pienkowski* and *Rogoff* found that it is challenging to pinpoint precisely when sovereign borrowing began, however, two

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[1] Kim Oosterlinck, 'The Historical Context of Sovereign Debt' in Ilias Bantekas and Cephas Lumina (eds), *Sovereign Debt and Human Rights* (OUP 2019) 13 (hereafter Kim Oosterlinck, 'The Historical Context of Sovereign Debt').

[2] ibid.

criteria can be used to 'identify when political entities first began making concerted use of marketable debt instruments'.[3] The first criterion is the 'existence of the sovereign governments necessary to issue sovereign debts'.[4] Another criterion is 'market constraints' which refers to 'the immediate demand for credit by the polity must exceed tax revenues and there is a sufficiently large number of individuals other than the sovereign must have wealth sufficient to lend substantial sums'.[5] For the following discussion, it is sufficient to define sovereign debt as a debt instrument owed by sovereign authority (such as central governments and central banks). There are two types of sovereign debts, including domestic debt (i.e. expressed by local currency, under local law, and held by local citizens) and external debt (i.e. expressed by foreign currency, under foreign law, held by foreigners, and issue directly in the capital market or borrow from the commercial banks).

Recently, China has received a wave of applications for debt relief due to the COVID-19 crisis, which hit those countries included in the BRI. Two shocks are going to hit the BRI's debt dynamics, which are a pandemic stimulus and post-pandemic economic fallout. Regarding the pandemic stimulus shock that hit the debt dynamics of the BRI, the economic fallout of the COVID-19 has pushed the sovereign states' governments (those participate in the BRI) take expansionary measures in this difficult situation. The increased of government expenditures during the pandemic raised the incentive of sovereigns to issue bonds offshore. Moreover, some BRI countries are considered to have a relatively high sovereign credit risk. For example, Sri Lanka ranks 56 out of 60 countries under the BlackRock Sovereign Risk Index.[6] Furthermore, Lebanon is expecting to its first sovereign debt default due to the financial crisis. The default of Lebanon caused big loses to creditors who invested in Lebanon's dollar debt. Therefore, it is foreseeable that the increasing trend of debt burdens in BRI countries pose serious challenges globally align with the contagion financial contagion between sovereign debt and capital markets. For instance, Pakistan has a higher financial risk than other sovereign bond issuers that may make sovereign debt unsustainable over the long-term.

Nevertheless, there is a general perception that sovereign debts represent a relatively small fraction of the overall capital market. History shown us that 'a complex network of sovereign debt can aggravate financial crises'.[7] The financial crisis of 2007-09 and the Eurozone financial crisis of 2010 showcased 'how external sovereign debts can play an aggravating role in global financial cycles'.[8] Sovereign default is one of the significant sources of systemic risk that contribute to financial crises. By studying the interwar period, it demonstrated the 'complex debt network with large common exposures can heighten risks to the global financial system in the absence of effective international institutions'.[9] Since the financial crisis of 2007-09, there has been increasing concerns over the sovereign debts. After the financial crisis of 2007-

[3] S. Ali Abbas, Alex Pienkowski and Kenneth Rogoff, *Sovereign Debt- A Guide for Economists and Practitioners* (Oxford University Press 2019) 8.
[4] ibid.
[5] ibid.
[6] BlackRock Investment Institute. '*BlackRock Sovereign Risk Index*' (BlackRock Investment Institute, July 2020) < https://www.blackrockblog.com/blackrock-sovereign-risk-indicator/> accessed 5 August 2020. (The counting of the overall score is based on the countries' fiscal space, willingness to pay, external finance position and financial sector health; and the number of BITs does not include treaties that have been denounced, terminated by mutual consent or renegotiated.)
[7] Mark De Broeck, Era Dabla-Norris, Nicolas End and Marina Marinkov, 'The Debt Web: The interwar period shows how a complex network of sovereign debt can aggravate financial crises' (2018) 55 (1) Finance & Development 30, 30.
[8] ibid.
[9] ibid.

09, 'central banks have underwritten a chronic growth environment to avoid acute failures'.[10] Although the impact of the financial crisis of 2007-09 has been reduced, the current sovereign debt market in BRI still poses serious challenges globally, which showed that it is necessary to establish a cross border sovereign debt dispute resolution regime among those countries joined the BRI, especially for SDR. As *Tobias Adrian*, the Financial Counsellor and Director of the Monetary and Capital Markets Department of the International Monetary Fund (IMF) has observed, '[s]ound debt management and the efficient functioning of sovereign debt capital markets is as important as ever, not least because debt levels are high and are likely to remain high'.[11]

It is necessary to understand the interrelationship between sovereign debt and the capital market before inquiring more deeply into the regulation of SDR. As suggested by *Smeets,* 'the topic of financial contagion had received high attention in the context of financial crisis related to currency and banking crises'.[12] Financial contagion has been defined as 'a situation that instability in a specific market or institution is transmitted to one or several other markets'.[13] Further, provided by *Dornbusch*, *Park*, and *Claessens*, financial contagion also refers to a phenomenon that 'a significant increase in cross-market linkages after a shock to an individual country (or group of countries), as measured by the degree to which asset prices or financial flows move together across markets relative to this co-movement in tranquil times'.[14]

Although the existing policies on sovereign debt in those BRI countries (particularly in China) aimed at containing spreading to instability, the actual financial contagion between sovereign debt markets and banks has been showcased during the European sovereign debt crisis.[15] Hence, it is most likely that international financial contagion would be more severe than presently observed if the various crisis management measures had not been taken in the BRI countries.

Ross noted that 'the problem of sovereign debt repayment has become one of the defining and most contentious political issues of our time' in light of 'the recent tumult in the global financial markets and the anti-establishment revolts the liberal world order'.[16] Furthermore, the history of sovereign debt showed that sovereign states governments usually repay their external debts and that global capital markets have been thriving despite the frequency and intensity of sovereign debt crisis in the last few decades is a clear indication of the fact that investors generally expect that the state governments to fulfil their international obligations.[17]

Reinhart and *Rogoff*'s research showed that banking crises (both domestic and those emanating from international financial centres) over the past two centuries (even those banking crises that is the purely private origin) 'increase the likelihood of a sovereign default'.[18] Also, it has been

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[10] Gene Frieda, 'Sovereign Debt Markets' in Rosa Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 307 (hereafter Frieda, 'Sovereign Debt Markets').
[11] Tobias Adrian, 'Keynote Address At 17th IMF Public Debt Management Forum' (Tokyo, Japan, 2020).
[12] Dieter Smeets, 'Financial Contagion During the European Sovereign Debt Crisis' (2016) 4 Journal of Economic & Financial Studies 46, 47.
[13] Vítor Constâncio, 'Contagion and The European Debt Crisis' (2012) 16 Financial Stability Review 109, 110.
[14] Stijn Claessens, Rudiger Dornbusch, and Yung Chul Park, *'Contagion: Understanding How It Spreads*' (2000) 15 The World Bank Research Observer 177, 178.
[15] ibid.
[16] Jerome E. Roos, *Why Not Default? The Political Economy of Sovereign Debt* (Princeton University Press 2019) 2.
[17] ibid 9, where Roos has discussed the reasons why state governments repay their debts.
[18] Carmen M. Reinhart and Kenneth S. Rogoff, 'From Financial Crash to Debt Crisis' (2011) 101 American Economic Review 1676, 1702.

noted that the 'financial repression and international capital controls may give the scope to the government to coerce healthy banks to buy government debt in a significant quantities'.[19] The banking crisis in the 1990s showcases these problems where government debt associated with nearly bankrupt state-owned enterprises.[20] The research also suggested that the 'debt cycles and their relative connections over the economic crisis have changed appreciably over time'.[21] Therefore, an effective mechanism to settle sovereign debt-related disputes in the future is necessary to prevent the next financial crisis.

In addition, the history of SDR has 'been primarily a story of muddling through'.[22] Since the emergence of the post-World War II international economic systems, policymakers across the globe 'have lamented the absence of a global SDR mechanism'.[23] SDR defined as 'changes in the originally envisaged debt service payments, either after a default or under the threat of default'.[24] SDR refers to 'an exchange of outstanding sovereign debt instruments', which is a process used by sovereign entities to avoid the risk of debt default of the existing sovereign debt or defer repayment.[25] *Guzman* and *Stiglitz* noted that 'the current system for SDR features a decentralized market-based process in which the sovereign debtor engages in intricate and complicated negotiations with many creditors with different interests', therefore, it often operates 'under the backdrop of conflicting national legal regimes'.[26]

III. Defects of The Current Approaches for Sovereign Debt Restructuring

As it stands currently, the current mechanisms to deal with SDR in the BRI countries are not harmonised, vary from country to country, and are mediated through a range of different procedures have been described as 'non-system'.[27] Further, commentators have observed that 'the "non-system" of SDR is solely lacking- fragmented, inconsistent, and providing insufficient relief to reboot economic growth'.[28] Even though the 'predicament of unsustainable sovereign debts existed as long as sovereigns have borrowed, the modern era of SDR started from the debt crises in the 1980s', which centred on the London Club mechanism.[29] In the 1980s, the world experienced a debt crisis since many Latin American countries were unable to service their external sovereign debts, which trigger numbers of SDRs. As a private creditor representative body, the London Club is the first multilateral forum that aims to manage commercial bank debt restructurings on an international basis since the 1980s. Unlike Paris Club, the London club has no fixed membership, no physical presence, and no secretariat. Instead, London Club operates on a case-by-case basis and the restructuring agreement between the creditor and the sovereign debtor. Therefore, those restructurings from

[19] ibid, 1690.
[20] ibid.
[21] ibid, 1702.
[22] Lee C. Buchheit and G. Mitu Gulati, 'Sovereign Bonds and The Collective Will' (2002) 51 Emory Law Journal 1318, 1323.
[23] Odette Lienau, '*The Challenge of Legitimacy in Sovereign Debt Restructuring*' (2016) 57(1) Harvard International Law Journal 151, 151 (hereafter Lienau).
[24] Jeromin Zettelmeyer, *Debt Defaults and Lessons from A Decade of Crises* (MIT Press 2007) 3.
[25] Udaibir S. Das, Michael G. Papaioannou, and Christoph Trebesch, 'Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts' (2012) IMF Working Paper WP/12/203, 7.
[26] Martin Guzman, José Antonio Ocampo and Joseph E Stiglitz, *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Oxford University Press 2016) 4 (hereafter Guzman, Ocampo, and Stiglitz).
[27] Anna Gelpern, 'Hard, Soft, and Embedded: Implementing Principles on Promoting Responsible Sovereign Lending and Borrowing' (2012) UNCTAD Principles, in Sovereign Financing and International Law 13.
[28] Lienau (n 23) 153.
[29] ibid, 177.

the 1980s (i.e. the success of London Club) have provided the 'foundations for the informal system' (also known as the non-system) that exists today.[30]

In China, the Supreme People's Court (SPC) has formally launched two branches of the International Commercial Court of China (CICC) in 2018 to adjudicate international commercial disputes. The establishment of the CICCs is driven by the desire of China to facilitate the dispute resolution related to the BRI. It has been noted that the 'SPC takes a flexible and pragmatic approach in the establishment of the CICC'.[31] While 'the current legal framework for the CICC came into shape, compared with other commercial courts in the globe, there are still ambiguities and obstacles in the operations of the CICC'.[32] For example, the CICC does not have jurisdiction over cases concerning investor-state disputes.[33] *Mollengarden* noted that 'providing a full menu of dispute resolution tools may enhance the demand for the services of CICC'.[34] For instance, the SICC covers:

> 'the subject matter of the claim arises from a relationship of a commercial nature, whether contractual or not, including (but not limited to) any of the following transactions: (A) any trade transaction for the supply or exchange of goods or services; (B) a distribution agreement; (C) commercial representation or agency; (D) factoring or leasing; (E) construction works; (F) consulting, engineering or licensing; (G) investment, financing, banking or insurance; (H) an exploitation agreement or a concession; (I) a joint venture or any other form of industrial or business cooperation; (J) a merger of companies or an acquisition of one or more companies; (K) the carriage of goods or passengers by air, sea, rail or road'.[35]

However, the SPC judge stated that the CICC will primarily accept international commercial disputes that arise between equal commercial entities.[36] Therefore, there is no bankruptcy court and code for those private investors in the belt and road to enforce debt obligations against those countries who cannot pay off its debt to initiate the SDR.

Recently, G20 countries have agreed on a Common Framework for debt treatments beyond the Debt Service Suspension Initiative ('DSSI'), with the endorsement by the Paris Club. The primary aim of the feature is to address the long-term debt sustainability problems faced by those poor countries in the aftermath of the COVID-19 pandemic, which attempts to deal with the problem of comparability of treatment with other creditors that have dogged the DSSI. Ever since its operation in May, the DSSI allowed 73 of the poorest countries in the world to suspend payments on bilateral loans which fall due in 2020. At the 15th G20 Leaders' Summit, President Xi Jinping confirmed that China will fully implement the DSSI. However, loans from Chinese

[30] ibid.
[31] Sheng Zhang, 'China's International Commercial Court: Background, Obstacles And The Road Ahead' (2020) 11 Journal of International Dispute Settlement 150, 161.
[32] ibid.
[33] ibid.
[34] Zachary Mollengarden, 'One-Stop' Dispute Resolution on the Belt and Road: Toward an International Commercial Court with Chinese Characteristics' (2019) 36(1) UCLA Pacific Basin Law Journal 65, 104.
[35] Andrew Godwin, Ian Ramsay and Miranda Webster, 'International Commercial Courts: The Singapore Experience' (2017) 18(2) Melbourne Journal of International Law 219, 226.
[36] CICC, 'The State Council Information Office Held a Press Conference on the "Opinion on the Establishment of 'The Belt and Road' International Commercial Dispute Settlement Mechanism and Institutions"' (28 June 2018) <http://cicc.court.gov.cn/html/1/219/208/210/769.html> accessed 9 May 2020.

financial institutions will not be considered as official lending under the eye of the Chinese government. This shows the limitations of the common framework.

Moreover, the current situation at the international level is a patchwork. It has been noted that the size of international sovereign lending has outgrown the capacity of the existing international financial architecture (i.e. comprises international financial institutions and treaties or agreements that regulate and backstop global financial system) to backstop illiquidity cases and safeguard the financial stability of the international financial markets.[37] Thus, the international community (including international, multilateral, regional agencies) has created numbers of approaches to resolve sovereign debt crises, namely the IMF's Proposed Features of a Sovereign Debt Restructuring Mechanism (SDRM),[38] UNCTAD Principles on Responsible Sovereign Lending and Borrowing (the UNCTAD Principles),[39] Principles for Stable Capital Flows and Fair Debt Restructuring, and European Monetary Union (ESM)'s framework. Apart from those international community's approaches, IIAs also largely affected the SDR process. Moreover, the contractual framework of sovereign debt instruments plays a vital role in facilitating the SDR process. Collective action clauses (CACs) 'have become a nearly invariable feature of sovereign debt documentation' in the globe.[40]

The IMF's SDRM was rejected in 2003 and the 'emerging markets precluded the introduction of an unfair, self-serving, and inefficient system', but the 'search for a viable solution is not over'.[41] *Raffer* noted that the IMF's SDRM is particularly unfair to private creditors and debtors since it reflects the 'strong institutional self-interest on the part of the IMF'.[42] *Euliss* argued that the IMF's SDRM is not supported by 'sound theory', rather, it is from a set of the 'flawed implementing procedure', which stated that the IMF's SDRM suffers from 'procedural inadequacies'.[43] For instance, 'the double role of the IMF as a creditor and adjudicator' has been criticised.[44] Also, other criticisms included 'the intervention in contractual rights', the potential impact on the cost of sovereign financing, and the move towards rules even though 'each sovereign insolvency has unique features that call for ad hoc solutions'.[45] According to *Eichengreen*, the main obstacle of the IMF's SDRM is the lack of political will to implement it.[46] There are few major reasons which contributed to the collapse of the IMF's SDRM. The

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[37] Frieda, 'Sovereign Debt Markets' (n 10) 308.
[38] International Monetary Fund (IMF), *Proposed Features of a Sovereign Debt Restructuring Mechanism* (Legal and Policy Development and Review Departments of the IMF, February 2003) <https://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf> accessed 13 May 2020.
[39] UNCTAD, Principles on Responsible Sovereign Lending and Borrowing (Amended and Restated as of 10 January 2012).
[40] Lee C. Buchheit and Elena L. Daly, 'Minimizing Holdout Creditors' in Rosa Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 22 (hereafter Buchheit and Daly, 'Minimizing Holdout Creditors').
[41] Kunibert Raffer, 'The IMF's SDRM—Simply Disastrous Rescheduling Management?' in Chris Jochnick and Fraser A. Preston (eds), *Sovereign Debt at The Crossroads: Challenges and Proposals for Resolving the Third World Debt Crisis* (Oxford University Press 2006) 263 (hereafter Kunibert Raffer, 'The IMF's SDRM—Simply Disastrous Rescheduling Management?'). (Raffer has discussed the IMF's SDRM thoroughly)
[42] ibid, 248.
[43] Richard Euliss, 'The Feasibility of the IMF's Sovereign Debt Restructuring Mechanism: An Alternative Statutory Approach to Mollify American Reservations' (2003) 19(1) American University International Law Review 108, 125.
[44] Michael Waibel, *Sovereign Defaults before International Courts and Tribunals* (Cambridge University Press 2011) (hereafter Waibel) 15.
[45] ibid.
[46] Barry Eichengreen, Toward a New International Financial Architecture: A Practical Post-Asia Agenda (Peterson Institute for International Economics 1999) 131.

IMF's SDRM failed to assuage the concerns of creditors that their protection required substantial strengthening.[47] *Setser* argued that sovereign debt issuers and private investors were unclear on the outcome that they are desired from a formalized process that they could already be obtained with the current contractual infrastructure.[48] It is uncertain for private investors who invest in sovereign debts to aware of how the IMF 'prioritize new financing without the possibility of asset seizure'.[49] Since the IMF's SDRM allowed the sovereign debt issuers to restructure its debts through an assent of a supermajority of creditors and a single aggregated vote. For this reason, *Setser* concluded that the IMF's SDRM did not provide any new protection and advantage to both of the sovereign debt issuers and private investors.[50] In the absence of new protection to private investors of sovereign debt, the impact of SDRM is small compared to that of IIAs in the field of SDR.

Although the IMF's SDRM has been rejected by its member states in 2003 and subjected to many criticisms, the IMF's SDRM could still be adopted as a useful framework for the effective control and regulation of SDR. Furthermore, *Mooney* asserted that a permanent international sovereign debt regime (i.e. the IMF's SDRM) is feasible and necessary since sovereign debt-related litigations are enormously costly.[51] For example, sovereigns 'like Argentina had devoted substantial resources to defending against lawsuits and attachment attempts, despite the fact that sovereign assets are very difficult to seize'.[52] The failed proposal of the IMF's SDRM needs to be revisited and improved. It is vital at this juncture to assess current progress towards the development of a global approach for SDR mechanism at the international level.

The failure of the SDRM proposal 'adds to a series of proposals which attempted to transpose features of domestic bankruptcy law and firm reorganisation law into the context of sovereign insolvency but never put to the test'.[53] The UNCTAD Principles is one of the proposals that contain obligations for both the sovereign debtor and creditors and emphasised the responsibility of both parties during different stages (such as the issuance of sovereign debt, negotiation and restricting process). But, the UNCTAD Principles 'do not provide for the establishment of an independent "court-like entity", such as an arbitration panel with the functions and powers of a bankruptcy court'.[54] Hence, the UNCTAD Principles did not provide adequate protection for sovereign bondholders.

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[47] Waibel (n 44) 15.
[48] Brad Setser, 'The Political Economy of the SDRM' in Barry Herman, José Antonio Ocampo, and Shari Spiegel (eds), *Overcoming Developing Country Debt Crises* (1st edn, Oxford University Press 2010) 318-346 (hereafter Brad Setser, 'The Political Economy of the SDRM').
[49] Aidan W. McConnell, 'A Different Kind of Restructuring: Forty Years of Debate and the Prospect of a Formal International Sovereign Debt Regime' (2016) CUREJ: College Undergraduate Research Electronic Journal, University of Pennsylvania, <http://repository.upenn.edu/curej/197> accessed 12 June 2020 13 (hereafter McConnell).
[50] Brad Setser, 'The Political Economy of the SDRM' (n 37).
[51] Charles W. Mooney Jr., 'A Framework for a Formal Sovereign Debt Restructuring Mechanism: The Kiss Principle (Keep It Simple, Stupid) and Other Guiding Principles' (2015) 37(1) Michigan Journal of International Law 57.
[52] Christoph Trebesch, and Henrik Enderlein, 'What Explains Sovereign Debt Litigation? Julian Schumacher' (2015) 58 (3) The Journal of Law and Economics 585, 586.
[53] Antonis Bredimas, Anastasios Gourgourinis, and Georges Pavlidis, 'The Legal Contours of Sovereign Debt Restructuring under the UNCTAD Principles' in Carlos Espósito, Yuefen Li, and Juan Pablo Bohoslavsky (eds), *Sovereign Financing and International Law: The UNCTAD Principles on Responsible Sovereign Lending and Borrowing* (Oxford University Press 2014) 135 (hereafter Antonis Bredimas, Anastasios Gourgourinis, and Georges Pavlidis, 'The Legal Contours of Sovereign Debt Restructuring under the UNCTAD Principles').
[54] ibid, 138.

The Principles for Stable Capital Flows and Fair Debt Restructuring were agreed and endorsed by the G20 Ministerial Meeting in Berlin in 2004, which 'constitutes a voluntary code of conduct between sovereign debt issuers and their private-sector creditors'.[55] Essentially, the Principles for Stable Capital Flows and Fair Debt Restructuring serves as a useful framework for crisis prevention and resolution, guiding, in particular, SDR from Greece to the Caribbean.[56] However, the major inconvenient of the Principles is that such a code, as self-fulfilling conduct, would not solve the problem of creditors' actions and minority blocking would continue.[57]

On 10 September 2015, the United Nations General Assembly adopted a draft resolution on 'Basic Principles on Sovereign Debt Restructuring Processes' (A/69/L.84).[58] In adopting the resolution, the UN General Assembly stated that SDR 'processes should be guided by customary law and by basic international principles of law, such as sovereignty, good faith, transparency, legitimacy, equitable treatment and sustainability'.[59] However, some creditor nations (notably the United States) disagreed with the draft, 'especially pertaining to the legal interpretation of some principles and to a preference by some Members to see international negotiations about sovereign debt restructurings hosted by the IMF'.[60]

Also, ESM (i.e. part of the European Monetary Union (EMU) architecture, which is a legally separate to the European Union (EU) with eurozone's 19 national governments as its shareholders) act as a crucial role for the financial crisis management. Nevertheless, the existing framework under the EMU is not adequate since it merely acts as a permanent mechanism for liquidity support. Even though there is no statutory SDRM takes place in the Euro area, there are still some measures for sovereign defaults, including collective action clauses (i.e. clause that allows creditors to agree on debt restructuring even when some creditors are against the restructuring as long as a majority agrees) and the performance of a debt sustainability analysis before the lending of ESM. Therefore, the way of how the EU community deal with the situations of insolvent sovereigns are still uncertain and vague.

Giving the fact that proposals like the SDRM, the UN and UNCTAD principles did not get traction in the international sphere, the contractual framework of sovereign debt instruments has been improved to facilitate the SDR process through clauses built into the agreement. *Buchheit* and *Daly* noted that 'CACs began to appear in New York law-governed sovereign debts from early 2003' and these 'have become a nearly invariable feature of sovereign debt documentation' in the globe.[61] Compared to the SDRM, CACs 'pursue a modest approach', which is a standardized provision in sovereign debt contracts providing procedural rules for default and restructuring.[62] However, many investors of sovereign debts hold the view that the

[55] IIF (2004) *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*. Report on implementation by the Principles Consultative Group. Washington DC: Institute of International Finance .
[56] ibid.
[57] Charlotte Julie Rault, *The Legal Framework of Sovereign Debt Management* (Nomos Verlagsgesellschaft 2017) 228.
[58] United Nations, '*United Nations General Assembly adopts basic principles on sovereign debt restructuring*' (United Nation, 11 September 2015) <https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=1074> accessed 22 April 2020.
[59] ibid.
[60] ibid.
[61] Buchheit and Daly, 'Minimizing Holdout Creditors' (n 29).
[62] Christian Hofmann, 'Sovereign-Debt Restructuring in Europe under the New Model Collective Action Clauses' (2014) 49 Texas International Law Journal 385, 390.

use of CACs in sovereign debts should not be encouraged.[63] This is because if sovereign debts contain CACs, those sovereign states are more likely to borrow recklessly as they can just cut a deal with those creditors later on.[64] Further, the collective account is not enough to protect creditors due to its limitations. For instance, one of the limitations is that each sovereign debt issue has a separate group of creditors, and CACs in a particular contract can only cater to the creditors of that contract.[65] Therefore, 'for a comprehensive exchange offer where the entire debt obligation of the state is sought to be restructured, the sovereign effectively needs to appeal to each bondholder separately'.[66]

IV. The Rise of International Investment Agreements and Arbitration

In recent years, there has been a considerable shift of the way to solve disputes concerning sovereign debts from litigation to arbitration. According to the Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights (Report), A/72/153 (2017),

> 'investment arbitration may open a new door for such creditors to deploy disruptive strategies. The current system of investment arbitration may therefore impair economic recovery and undermine State funding for public services and State institutions that give effect to economic, social, cultural rights and the protection of civil and political rights'[67]

Furthermore, *Gellagher* identified 'there is an increasing concern that IIAs', and arbitration aroused by those IIAs 'may become the "court" for sovereign workouts by default'.[68] There are a total of 3160 BITs among those countries which have issued sovereign debts, in which there are a total of 2702 BITs that have entered into force.[69] It further showed that there are approximately 85% of the BITs have been entered into force.[70] Thus, IIAs act as an important role in the development process of an essential financial legal regime in SDR.

Chaisse has acknowledged that there are mainly two types of IIAs that can be used to protect the rights of private investors (also called as creditors) who invested through sovereign debts. These two types of IIAs included BIT and Preferential Trade Agreement.[71] In 2007-2008, Greece was suffering from the financial crisis, which caused the Greek government failed to

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[63] David Billington, 'Effective Collective Action Clause' in Rosa Lastra and Lee Buchheit (eds), *Sovereign Debt Management* (Oxford University Press 2014) 403.

[64] Sönke Häseler, 'Collective Action Clauses in International Sovereign Bond Contracts – Whence the Opposition?' (2009) 23 Journal of Economic Surveys 882.

[65] Joy Dey, 'Collective Action Clauses Sovereign Bondholders Cornered' (2009) 15 Law and Business Review of the Americas 485, 509.

[66] ibid, 509.

[67] United Nations, 'Report of The Independent Expert on The Effects of Foreign Debt and Other Related International Financial Obligations of States on The Full Enjoyment of All Human Rights, Particularly Economic, Social and Cultural Rights' (2017) 2 (hereafter United Nations).

[68] Kevin P. Gallagher, *'The New Vulture Culture: Sovereign Debt Restructuring and Trade and Investment Treaties*' 2011 IDEAs Working Paper No. 02/2011 <https://pdfs.semanticscholar.org/23da/8278687167967eef5b9608d20d70fc47d024.pdf> accessed 23 January 2020 (hereafter Gallagher).

[69] UNCTAD, '*Investment Policy Hub*' (UNCTAD, July 2020). <http://investmentpolicyhub.unctad.org/IIA/IiasByCountry#iiaInnerMenu> accessed 23 July 2020.

[70] ibid.

[71] Julien Chaisse, *Legal Problems of Economic Globalisation: A Commentary on The Law and Practice* (1st edn, Wolters Kluwer 2015) 281-283.

meet its repayment obligation to its creditors. Therefore, creditors of the Greek sovereign bonds have filed a claim against the Greek government through the Greek BIT. This case showed that IIAs are important for the protection of creditors who invested through sovereign debts. For instance, the first reason is that the coverage of IIAs are broad generally, which means that most of the investors who engaged in foreign investments can be protected. Furthermore, as evidenced by the provisions stated in the Greek BIT, the investor-state dispute settlement procedures are considered as efficient instruments for the protection of sovereign debt's creditors.

Also, both of the decisions made in the cases of *Abaclat*[72] and *Greek*[73] showed that there are different methods to address the different needs of the parties in the cases of SDR. Also, the Greek and the *Abaclat* have different findings on jurisdiction. Therefore, it is difficult to certain the outcome of the SDR by merely reading those IIAs' provisions. However, the tribunal in the case of *Abaclat* made two novel findings that will potentially expose sovereign debt issuers to future investment arbitration claims: first, *Abaclat* is the 'first decision to hold that an arbitral tribunal has the legal authority to hear claims that a sovereign's default and debt restructuring may have breached a BIT'; second, this case is 'the first arbitral decision to hold that 60,000 Claimants may join in one mass claims arbitration under the institutional rules of the International Centre for Settlement of Investment Disputes (ICSID)'.[74] If the decision is followed in the future, it has a potentially significant impact on SDR, 'the drafting of arbitration clauses', and 'the scope of ICSID jurisdiction over mass claims arbitrations'.[75] Hence, BITs, as a type of IIAs, act as a crucial role in SDR.

Moreover, *Thrasher* and *Gallager* reaffirmed the increasing trend that IIAs have begun to act as a crucial role in the SDR, in particular, as a tool for the protection of private investors.[76] Furthermore, *Thrasher* and *Gallager* alleged that investor-state claims through IIAs are a method for investors of those sovereign debts to claim the full amount of their original investments. Accordingly, it could be asserted that, to a large extent, IIAs and investors-states arbitrations form parts of the international financial legal regime in SDR.

It has been noted in the Report that investment arbitration is an adequate option for solving disputes in the context of SDR.[77] Arbitration is considered as a more preferable way for creditors who do not want to accept take it or leave it offers as well as who was rejected by the national courts to file their claim against the sovereign debtors. When comparing traditional litigations and arbitrations, litigations are not always the appropriate way to settle SDR disputes. This is because comprehensive technical knowledge is necessary to decide those SDR related cases and arbitration is usually far less costly than proceeding through litigation. Besides, most of the sovereign debt obligations are covered by IIAs, creditors may use investor-state dispute settlement to pursue their financial interests. The increasing trend of the SDR process to be subjected to IIAs and investors-states arbitrations provide a strong foundation for the establishment of an international arbitration and mediation centre for sovereign debt disputes. However, it is not always the case that the SDR process is subject to IIAs. For instance, most

[72] Abaclat and Others v. Argentine Republic, ICSID Case No. ARB/07/5.

[73] Poštová banka, a.s. and ISTROKAPITAL SE v. Hellenic Republic, ICSID Case No. ARB/13/8.

[74] Jessica Beess und Chrostin, 'Sovereign Debt Restructuring and Mass Claims Arbitration before the ICSID, the Abaclat Case' (2012) 53 Harvard International Law Journal 505, 505.

[75] ibid.

[76] Rachel D. Thrasher and Kevin P. Gallagher 'Mission Creep: Emerging Role of International Investment Agreements in Sovereign Debt Restructuring' (2016) 6 (2) Journal of Globalization and Development 257.

[77] United Nations (69).

of the BITs between China and the countries took part in the belt and road initiative are very conservative as to the scope of the disputes that could submit to international arbitration.[78]

Further, as an option for solving SDR related disputes, investment arbitration has been criticised for various reasons. For instance, it could be problematic for putting sovereign states (with multiple and complex economic and social commitments to their citizens) on the same legal footing as private investors and financial institutions in the arbitration proceedings due to the fundamental difference of their legal status. Also, there is a question concerning whether sovereign debt arbitration should administer as private debt. Further, *Megliani* argued that 'arbitration should be avoided as a mean' to solve sovereign debt dispute based on three reasons.[79] First, 'creditors may prefer submitting to arbitration to avoid taking part in restructuring processes so as to get their claims in full'.[80] This might constitute as an abuse of process in international arbitration since creditors are using the arbitration process as a mean to get their claims in full rather solving their disputes. Second, 'arbitral tribunals are insufficiently equipped to appreciate the economic situation of a debtor country as a whole'.[81] The arbitrators' lack of knowledge may cause the arbitration to stumble by making the wrong decision. Third, 'arbitrators do not give due consideration to the human rights aspects of the claims'.[82] Generally speaking, the role of arbitrators is to issue an arbitral award based on the testimony and evidence provided by the parties in the dispute. Arbitrators tends to not consider human rights in the arbitration proceeding (as well as in their award) due to 'the consent to arbitration by investors is generally contained in the request for arbitration and is limited to the scope of the request'.[83] Therefore, arbitration is not an ideal forum to settle disputes related to sovereign debt restructuring.

V. Calls for a Global Approach for Sovereign Debt Restructuring

Historically, sovereign debt has been regarded as one of the safest investment assets when compared with other investment vehicles like stocks and corporate bonds. This is because governments are unlikely to default on their debts. Therefore, sovereign debt has low credit risk as the sovereign state backs it. The fundamental problem of sovereign debt is 'the difficulty to enforce sovereign debt contracts'.[84] Sovereign debts, as debt securities issued by sovereign governments, are different from the debts of private entities in at least two important respects. As identified by *Wright*, the first difference arises from the special legal status of a sovereign arising from the doctrine of sovereign immunity (i.e. a sovereign state cannot commit a legal wrong and is immune from enforcement and execution), which 'precludes a lawsuit again a sovereign state without that sovereign's consent'.[85] Hence, it is difficult for creditors of sovereign debt to enforce the sovereign debt contract. However, the absolute doctrine of sovereign immunity has been weakened due to the 'increased government participation in commercial activities in the post-war period'.[86] In response to the increased of states'

[78] Shu Zhang, 'China's Approach in Drafting the Investor–State Arbitration Clause: A Review from the "Belt and Road' Regions" Perspective' (2017) 5(1) The Chinese Journal of Comparative Law 79.
[79] Mauro Megliani, 'Thou Shalt Not Arbitrate: Sovereign Debt and Investment Arbitration' (2018) 35 (5) Journal of International Arbitration 599, 600.
[80] ibid.
[81] ibid.
[82] ibid.
[83] ibid, 611.
[84] Mark L. J. Wright, 'Sovereign Debt Restructuring: Problems and Prospects' (2012) 2 Harvard Business Law Review 153, 158 (hereafter Wright).
[85] ibid, 156.
[86] ibid.

participation in commercial activities, states have introduced legislation on sovereign immunity. For instance, both the United Kingdom's State Immunity Act 1978[87] and the United States Foreign Sovereign Immunity Act 1976[88] had to grant sovereign immunity to the sovereign states unless they are acting in a commercial capacity. In the *Republic of Argentina v. NML Capital, Ltd.*,[89] the Supreme Court of the United States held that commercial activity exemption applies to sovereign states which issue sovereign debts. The second difference between sovereign and private debs 'arise from the relatively limited scope for the attachment of the assets of the sovereign' states.[90] The 'difficulty of enforcing sovereign debt contracts limits many potentials changes to the process for SDR that rely on being able to bind the sovereign to accept an agreement'.[91] Also, sovereign 'default may impose direct costs on the economy of the defaulting countries'.[92] Therefore, the reform of the SDR process is necessary to reduce 'the costs (in terms of both time and other resources) associated with reaching agreement as to the terms of that restructuring'.[93]

Furthermore, the recent episodes of SDR in Greece and Argentina showed the defects of the current approach for SDR (i.e. the combination of the contractual approach and the official intervention by the IMF). The financial crisis in 2008 (i.e. the Lehman crisis) and the European sovereign debt crisis in 2012 showed that debt crises would 'lead to systemic crisis'.[94] *Lipp* identified four fundamental characteristics of modern capitalism that makes it is much more fragile than 100 years ago. First, the complexity and opacity of the markets could lead to a systemic crisis in modern capitalism. For instance, banks and individual bondholders react in the same way in the financial market where their fear will endanger by counterparty risks.[95] Secondly, the transmission of defaults from one place in the world to others is unpredictable, which would create 'uncertainty over the market'.[96] Thirdly, financial markets are not stable, and the systemic crisis will be entered after the default of an industrial country under the current international financial regulatory regime.[97] This is because the sovereign debts serve as securities for billions of financial transactions, which are substitutes of liquidity in the balance sheet of banks.[98] The last constituent characteristic is that the placement of sovereign debts 'in international financial markets has weakened the discipline of states to guarantee the debt service'.[99] Since sovereign states can issue bonds in the international financial markets, the reputation risk for them to not pay back their debt is lower when compared to the old days where sovereign states can only issue bonds in the domestic markets. This is because 'debt holders and the electorate were the same community'.[100] It illustrated the importance of a global approach for SDR for the international financial market due to the increase of financial fragility.

[87] State Immunity Act 1978.
[88] Foreign Sovereign Immunities Act 1976.
[89] Republic of Argentina v. NML Capital, Ltd., 573 U.S. (2014).
[90] Wright (n 84), 157.
[91] ibid, 158.
[92] ibid, 159.
[93] ibid.
[94] Michael Waibel, 'The Historical Experience and Economics of Sovereign Debt' in Christoph G. Paulus (ed), *A Debt Restructuring Mechanism for Sovereigns: Do we need a legal procedure?* (Hart Publishing 2014) 35 (hereafter Waibel, 'The Historical Experience and Economics of Sovereign Debt').
[95] ibid.
[96] ibid.
[97] ibid.
[98] ibid.
[99] ibid.
[100] ibid.

Additionally, the Argentine default leading to the United Nations General Assembly (UNGA) Resolution 68/304, 'Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes' (UN Plan),[101] which has been passed by a split vote in 2014. This has expressed the will of many member states of the UN to move toward the development of a multilateral framework for SDR. Therefore, it affirmed *Mooney*'s argument that a permanent international sovereign debt regime is necessary and feasible. Hence, the SDR in the contemporary global economy is towards an international financial legal regime in SDR and China, as the leader of BRI, shall take a lead to establish an international financial legal regime in SDR.

As mentioned, the size of international sovereign lending has outgrown the capacity of the existing financial architecture to backstop illiquidity cases, and the complexity of collective action problems in the resolution of future sovereign debt crises. However, *Frieda* argued that 'these worries are overblown'.[102] This is because the sovereign borrowing market has remained steady,[103] and 'demonstrated incredible resilience despite a century of dramatic political and economic upheaval'.[104] Even though the current sovereign borrowing market is stable and resilient, the current approach for SDR is still a patchwork and fragmented. Also, 'negotiations to restructure sovereign debt are time-consuming', in particular for those negotiations take place in a 'weak contractual environment'.[105] For instance, on average, negotiations to restructure sovereign debt taking 'more than six years to complete'.[106] The current approach for SDR is unpredictable, disorderly, and provides insufficient relief for economic growth. The cost of SDR for the sovereign debtors and creditors will be lower if there is a global approach for SDR. Further, the efficiency of the international capital markets will be enhanced. Some scholars claimed that a clear SDR framework 'stipulates a creditor bail-in would help with the respect to burden-sharing (similar to the bail-in rules for the banking sector)'.[107] Also, it has been argued that it will boost the financial crisis prevention since 'a mechanism to regulate SDR incentivizes creditors to assess risks as accurately as possible and to factor them in using risk premia' for sovereign debts.[108] Apart from strengthening the discipline of the market, a clear regulating regime for SDR may also prevent excessive market movements.[109] A reform of the SDR mechanism would reduce the risk of destabilising market volatility caused by uncertainty.[110] Thus, an international regime for SDR is necessary to stabilise the international financial market and SDR is an issue that worth discussing and examining.

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[101] United Nations, '*Resolution 68/304. Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes'* (United Nations, 9 September 2014) <http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/68/304&Lang=E> accessed 9 June 2020.

[102] Frieda, 'Sovereign Debt Markets' (n 10) 308.

[103] ibid.

[104] Odette Lienau, *Rethinking Sovereign Debt: Politics, Reputation, And Legitimacy in Modern Finance* (Harvard University Press 2014) 1.

[105] Rohan Pitchford and Mark L. J. Wright, 'Holdouts In Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment' (2012) 79 The Review of Economic Studies 812, 812. (Pitchford and Wright have characterized the 'weak contractual environment' by five key features.)

[106] ibid.

[107] Jochen Andritzky, Désirée I. Christofzik, Lars P. Feld, and Uwe Scheuering, 'A mechanism to regulate sovereign debt restructuring in the euro area' (2018) 22 (1) International Finance 20, 21.

[108] ibid.

[109] ibid.

[110] ibid.

VI. Impact of COVID-19 to the Drafting of Future IIAs Between China and other BRI Countries:

Potential change of the drafting of future IIAs between China and other BRI countries is required in the post-COVID era. In the future, the drafters of IIAs shall anticipate COVID-19 (or other similar global health pandemic) impacts by anticipating the extent to which an investment agreement may be impacted. For instance, the drafter can draft the future IIAs in a way that can identify the parties that will have difficulty fulfilling their obligations and the situations that could give rise to a breach of IIAs. On the other hand, from the defaulting States' perspective, it could be argued that BITs that include investor-State dispute settlement bring more risks than benefits. In the future, defaulting States might consider taking India as a reference, to exit most of the BITs. The lack of political will of defaulting States might be the potential hurdle for the establishment of international arbitration for sovereign debt-related disputes.

VII. Potential Reform

Most of the BITs between China and the countries took part in the BRI are very conservative on the scope of the disputes that can submit to international arbitration.[111] To meet the particular needs in sovereign debts disputes, the Chinese government shall consider establishing an international arbitration and mediation centre and specific arbitration, mediation, and expert determination regimes for sovereign debt-related disputes with the assistance of the United Nations Commission on International Trade Law (UNCITRAL) Working Group III (Investor-State Dispute Settlement Reform). However, the idea of a unified SDR regime by IMF is not novel. The failed proposal of the IMF for SDRM is one of the examples. The IMF's SDRM needs to be revisited and improved for the establishment of an international regime for sovereign debt disputes. It is vital at this juncture to assess current progress towards the development of a global approach for SDR related disputes at the international level. The proposed applications of an international regime for sovereign debt disputes would provide better protection for the investors.

The objective for the IMF's SDRM is to provide a framework for the Chinese government to facilitate the incentives between the sovereign debt issuers and creditors to reach an agreement that is mutually beneficial to both of them in terms of its cost and efficiency. Further, the SDRM is the strongest attempt made by the international community to institute a permanent restricting in recent years. However, the IMF's SDRM has been rejected in 2003 due to the uncertainty of the desired outcome that the sovereign bond issuers and private investors can anticipate. Although the IMF's SDRM has been rejected by its member States and subjected to many criticisms, the IMF's SDRM can still be adopted as a useful framework for the effective control and regulation of SDR. More importantly, an international arbitration and mediation regime for SDR in BRI countries is crucial in the contemporary moment due to the enormously high cost for sovereign debt-related litigations.

Lack of truly independence and impartiality of arbitrators is one of the key backlashes of the current investor-state arbitration system. The establishment of an international regime for sovereign debt disputes can administer a comprehensive list of sovereign debt expert acting as arbitrators or mediators. In order to uphold the independence and the impartiality of the list of the arbitrators, the China government could take the composition of the European Court of Human Rights (i.e. elected by the Parliamentary Assembly of the Council of Europe from lists

[111] Shu Zhang, 'China's Approach in Drafting the Investor–State Arbitration Clause: A Review from the "Belt and Road' Regions" Perspective' (2017) 5(1) The Chinese Journal of Comparative Law 79.

of three candidates proposed by each State) as a reference. The composition of the list could be proposed by each BRI countries. Further, a specific set of rules can be developed for solving disputes in the context of sovereign debts. Most importantly, the IMF could develop a model dispute resolution clause for sovereign bond issuers. The IMF can take the World Intellectual Property Organisation's model alternative dispute resolution clauses as a reference, it can provide a set of recommended contract clauses (for the submission of future disputes under a particular contract) and submission agreements for the sovereign debt issuers.

VIII. Conclusion

Building on the above analyses, it has been shown that a coherent and comprehensive global approach for SDR is necessary to strengthen and safeguard the global financial system. The existing safeguards for SDRs are not sufficient and adequate. Besides, the SDR in the contemporary global economy is moving towards an international financial legal regime in SDR. The Chinese government can take the lead to establish an international arbitration and mediation centre and specific arbitration, mediation, and expert determination regimes for sovereign debt-related disputes with the assistance of the UNCITRAL Working Group III (Investor-State Dispute Settlement Reform). The establishment of an international arbitration and mediation centre and specific arbitration, mediation, and expert determination regimes will enhance the stability of the international financial markets.

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